STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

South Beloit Water, Gas and Electric Company	)	03-0676
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Proposed general increase in natural gas rates.	)	Cons.
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South Beloit Water, Gas and Electric Company	)	03-0677
	)	
Proposed general increase in water rates.	)	

REPLY BRIEF OF THE STAFF
OF THE ILLINOIS COMMERCE COMMISSION

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NOW COMES the Staff of the Illinois Commerce Commission ("Staff") through its attorney, and files its Reply Brief in the above-captioned proceeding.

INTRODUCTION

Initial Briefs were filed by Staff and South Beloit Water, Gas and Electric Company ("SBWGE" or "Company"). Staff will respond to certain arguments made by the Company. Staff's silence to other arguments raised by the Company should not be construed as acquiescence in or approval of said arguments by Staff.

ARGUMENT

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The Company fails to identify any quantifiable evidence to support its position that it be allowed to recover previously incurred savings sharing cost from its general customer base. Similarly, the Company fails to identify rules, laws, specific policy, or even applicable precedent in support of its position. Rather the Company relies on subjective and intuitive argument in defense of an otherwise indefensible request.

One could question the sincerity of the Company's request that savings sharing cost be recovered from the general customer base when confronted with the following statement from the Company, "(s)hared savings is designed to help Illinois <u>businesses</u> make energy saving, cost saving, and process improvements with little or no upfront investment of time or money." (Emphasis added) (SBWGE Initial Brief, pp. 12-13) That statement raises many concerns. First, customers of SBWGE should not be expected to foot the bill for business entrepreneurs. Second, businesses are not entitled to receive energy saving, cost saving, and process improvements "with little or no upfront investment of time or money".

While it might be nice if everybody could save energy, cost, and benefit from improvements with little or no upfront investment of time or money on their part, someone has to pay for it. However, that someone should not be ratepayers who are not receiving the benefit. While the Company's arguments might be welcomed by a select few business people who cannot, or choose not, to make appropriate investments; most people, and our economic system, would expect that individuals who are in business and reap the rewards of their businesses, are the proper source of investment, not utility customers.

According to the Company this "…program removes barriers to enable customers to install energy efficient equipment. This direct involvement assists customers who are not able to invest the time necessary to learn about the most efficient technology or to install equipment that achieves energy savings." (SBWGE Initial Brief, p. 13) This statement at best is only misleading. Out of a total customer base of 6,857, only 14 are participating in the savings sharing program. (Tr. 52) In Staff's opinion it is not accurate to describe this program as benefiting customers when such a small proportion actually participate. Perhaps the small participation level is an indication that only 14 customers are not able to make the effort to find out how to improve the efficiency of operations. In any regard, it is not proper to expect that 6,000 customers will subsidize the half score of businesses on SBWGE's system that are unable to properly manage their operations.

The Company states, "…SBWGE continued its Bright Ideas for Business in the form of Shared Savings to addresses (sic) the customer barriers of a lack of knowledge, lack of time, lack of capital, and risk avoidance." (SBWGE Initial Brief, pp. 13-14) Again, Staff notes that the program is not available to all customers and is only actually used by 14. However, even if 28 customers used the program, the fact is, SBWGE is not a business consulting firm. But, if it were in the enterprise of providing consulting services, Staff would expect that it would insist that its clients pay for those services. In this case SBWGE is not only providing consultation free of charge to the 14 participants, it expects the general customer base to pay for SBWGE's administrative fee, a portion of the financing cost, that it does not charge the plan participants.

The Company states, "(c)ustomer personnel do not have the resources to research internal energy utilization, much less all the equipment and vendor claims they receive which promise to save money, improve their efficiency or make their jobs easier." (SBWGE's Initial Brief, p. 14) It appears that the company is suggesting that it is indeed offering consulting services. While Staff is not taking a position on the merits of the Company's consulting enterprise, there is no quantified evidence of record that the consulting service provides the general customer base with any benefits and there is no reason that the customers should be required to pay the cost of the consulting service.

The Company's brief actually provides ample argument to deny the recovery of the shared savings cost. SBWGE states,

> Unfortunately, many energy efficient projects are not perceived to have sufficiently competitive paybacks to be considered for implementation. Also, non-residential customers typically need an additional financial incentive in order to implement an energy efficient project because of SBWGE's relatively low electric and gas rates.

(SBWGE Initial Brief, p. 14) If the benefit of the investment does not exceed the cost and if the Participants in the shared savings program need an extra financial incentive;

then the savings to be generated does not justify the investment. The investment should not be made in the first place, and any subsidy by the utilities customers is "sending good money after bad." Certainly the entire concept of public utility operations recognizes a sharing of benefits and costs; however, the Company's proposal goes well beyond sharing to the point of wholesale subsidies by all customers for the benefit of 14 participants.

The Company continues to argue for the shared savings program by stating, "…they avoid these projects because they do not want the risk associated with a problem or no savings." (SBWGE Initial Brief, p. 15) The Company is suggesting that because the participants are unwilling to risk an investment, the customers should be required to risk an investment in another entities operations, even though the customers will receive no return on that investment.

The inequity of this program to the general customer base is revealed in the following mischaracterization:

> Therefore, Shared Savings minimizes the customer's [i.e. participant's] risk because SBWGE guarantees a positive cash flow. There is no risk of a negative cash flow due to implementing any project. (Explanation added)

(SBWGE Initial Brief, p. 15) In a sense, Staff supposes that the Company is correct. There is no <u>risk</u> of a negative cash flow; but rather, a negative cash flow is guaranteed. The participant may not lose, but under the Company's proposal, it and ultimately the general customer base, who are paying a portion of the participants' cost of financing will experience a negative cash flow.

It is significant that the Company misstates the issue when it states, "…SBWGE believes that it has established its burden and that the costs that it has incurred regarding Shared Savings are just and reasonable." Staff is not arguing that the costs are unjust or unreasonable. Staff's point is that the participants, not the general customer base, benefit from the shared savings costs. It is just and reasonable that the participants, not the general customer base, pay the cost. (SBWGE Initial Brief, p. 17)

The Company's characterization that, "(s)taff believes that demand side energy programs such as Shared Savings only confer benefits to industrial and commercial customers" is wantonly misleading. (SBWGE Initial Brief, p. 17) Mr. Smith states, "(t)his savings sharing program is a benefit to only certain industrial and commercial customers. " (emphasis added) (ICC Staff Exhibit 3.0, p. 11) For the Company to suggest that Mr. Smith is speaking to the policy issues associated with demand side energy programs is an insincere attempt to disparage the validity of his concern. Mr. Smith is addressing a specific program and the facts attributable to that program. He is not addressing demand side energy programs because demand side energy programs are not at issue in this docket. It also needs to be pointed out that any suggestion contained in this mischaracterization that the program is available to customers other than industrial and commercial customers is equally false. During cross-examination, Mr. Carlson, when provide a list of shared savings participants was unable to identify even one as being a residential customer. (Tr. 125-126)

That the Company's position is without merit is obvious from the statement, "(a)bsent a showing the (sic) SBWEG's Shared Savings program is unjust and unreasonable, the Commission must reject Staff's recommendation to exclude SBWGE's Shared Savings expenses." (SBWGE Initial Brief, p. 18) By virtue of its failure to claim that it has proven that the expenses are just and reasonable, not only does the Company admit that it has failed its burden, it is now attempting to shift that burden to Staff. Neither Staff, nor any other party, must prove expenses to be not just and unreasonable; rather, the burden is on the Company to prove that all expenses are just and reasonable. (220 ILCS 5/9-201(c)) However, the question is not whether the costs are just and reasonable, but who will pay for those costs. As fully explained in Staff's Brief, because the participants receive the benefits, it is reasonable that they pay the cost. (Staff Initial Brief, p. 17)

The Company claims that "(s)taff has lost sight of the fact that SBWGE is obligated to evaluate its demand side obligations under the PUA." (SBWGE Initial Brief, p. 18) Staff has not lost sight of anything but it does question how a program that has 14 participants, compared against approximately 6,000 customers can materially impact demand. Furthermore, if this program is of value to the Company's demand management, it is of value because it helps the participants reduce their energy consumption. It is realistic, that the customers who receive the direct reduction in gas cost, pay for the assets that lead to that reduction in cost.

The Company appears to suggest that because the costs that it seeks to recover would represent amortization of past cost, then the nature of the cost is some how changed to a future cost, and thus the issues of single issue and retroactive ratemaking go away. (SBWGE Initial Brief, p. 20) Common sense requires us to conclude that rates established to be charged for future service must reflect future cost of providing that service, not cost for past service. And, it is clear from the Company's testimony that the savings sharing cost at issue in this Docket was incurred prior to 2003. (Tr. 70) The Company is essentially arguing that if the Commission approves the recovery of past shared savings cost, those costs will become future costs, and they promise to amortize those costs for accounting purposes. The nature of the costs as past cost is absolutely fixed when the cost is incurred. Amortization could be appropriate, but those costs can never be incurred in the future because the have been incurred in the past. The Company has not explained why they should be permitted to recover past costs from future customers paying for future service.

In support of its position, the Company cites Illinois Bell Telephone Co. v. Illinois Commerce Commission and Citizens Utility Board v. Illinois Commerce Commission. (SBWGE Initial Brief, p. 20) However, SBWGE fails to consider Business and Professional People for the Public Interest v. Illinois Commerce Commission, 146 Ill. 2d 175, 240-241 (1991) (BPI II). Under BPI II these types of costs are period costs subject to test-year principles and therefore, they cannot be deferred and included in rates to be recovered from future operations.

A final point made by SBWGE is, "(a)s a result (of the shared savings program) the Company is better able to manage its peak demand costs and avoids costs it may otherwise expend expanding its system to meet that demand." (SBWGE Initial Brief, p. 21) May otherwise expend? Beyond the speculation in this statement, the Company is once again claiming that it is saving money for all customers, but it has failed to quantify those savings. One must wonder, how much savings could be generated as a result of the 14 customers who participate in the program.

As more fully addressed in Staff's Initial Brief and above, recovery of the shared savings cost from the general customer base should be denied. The costs were incurred prior to the test year in this docket and recovery would constitute retroactive ratemaking. If the participants want to pay the cost of the assets that provide gas service to them, that is fine, however, non-participating customers should not be required to subsidize the asset purchases of the participants in the plan.

h. Customer Accounts Expense- *Water*

i. Interest Expense Related to Customer Deposits- *Water*

E. Cost of Capital- *Gas & Water*

Staff and SBWGE agreed on the appropriate capital structure and costs of short-term debt, long-term debt, and preferred stock for the gas and water operations of SBWGE. Their sole difference of opinion lies in assigning the proper costs of common equity within the agreed capital structure.

1. Capital Structure- *Gas & Water*
2. Cost of Short-Term Debt- *Gas & Water*
3. Cost of Long-Term Debt- *Gas & Water*
4. Cost of Preferred Stock- *Gas & Water*
5. Cost of Common Equity- *Gas & Water*
    a. Company Analysis & Recommendation- *Gas & Water*
    b. Staff Criticism of Company's Analysis- *Gas & Water*
        i. Mr. Bacalao's Sample

SBWGE claims that Mr. Bacalao selectively screened for companies with risk profiles similar to SBWGE in forming his sample group. (SBWGE Initial Brief, p. 29) However, the screening criteria he used selected companies with higher risk profiles than the gas and water utility operations of SBWGE. Therefore, Mr. Bacalao's sample does not conform to the requirements of Section 9-230. His cost of equity estimates reflect the risk of Alliant's non-regulated operations and should be rejected. In forming his sample, Mr. Bacalao relied on Alliant's safety rank and the current credit rating of WPL. The testimony of Staff witness Freetly thoroughly supports her position that downgrades to Alliant's credit ratings due to investment in higher-risk nonregulated businesses caused the downgrade of WPL. (Staff Initial Brief, pp. 25-27) Since the factors used to assemble Mr. Bacalao's sample group assumed a higher level of risk than inherent in the gas and water operations of SBWGE, his cost of equity analysis produces inflated cost of equity estimates.

ii. Comparable Earnings

iii. Risk Premium Model

iv. CAPM Analysis

SBWGE claims that since the companies in his sample have different leverage, their betas as shown in Value Line are not comparable. (SBWGE Initial Brief, p. 31) To make them comparable, Mr. Bacalao took the levered betas, un-levered them, and then re-levered them based on the estimated leverage of WPL. A levered beta measures the systematic risk for the equity shareholders of the company and illustrates a security's volatility in relation to the market. This leverage adjustment increased the implied risk of the sample relative to SBWGE and thereby further inflated SBWGE's cost of equity estimates. (Staff Initial Brief, pp. 32-33)

v. DCF Analysis

c. Staff's Analysis & Recommendation- *Gas & Water*

i. DCF Analysis

ii. Risk Premium Analysis

iii. Recommendation

d. Staff Response to Company's Criticisms- *Gas & Water*

Staff's analysis is consistent with previous Commission decisions. Staff consistently followed accepted theoretical models and used market-determined values to the extent feasible. SBWGE's cost of equity analysis employed methodologies that the Commission has consistently rejected. Hence, Staff's cost of equity recommendation should be adopted because it does not inflate SBWGE's allowed return due to the higher level of risk of its parent company in accordance with Section 9-230, it is derived using theoretically sound financial models, and the results are more forward-looking than the Companies' results that rely more heavily on historical data.

i. Samples

SBWGE claims that Staff relied only on debt credit ratings as a measure of equity investment risk. (SBWGE Initial Brief, pp. 35-36) However, Staff relied on S&P credit ratings and business profile scores when selecting companies to serve as proxies for SBWGE. The credit ratings represent the financial risk of the companies to which they are assigned, whereas the business profile scores represent the business risk to which those companies are exposed. Hence, Staff's sample selection methodology is based on the total risk of the gas and water utility operations of SBWGE.

SBWGE continues to criticize Ms. Freetly's sample groups because the average business profile score of her samples is 3, while WPL's business profile score is 4.

(SBWGE Initial Brief, pp. 39 and 41) WPL's business profile score reflects the total business risk of WPL as a provider of electric, gas, and steam services. As Ms. Freetly has explained, a business profile score of 3 is more representative of the average business profile score of gas and water utilities. (Tr. 207-213; Staff Initial Brief, p. 40) In most cases, S&P categorizes pure gas distribution companies as having well-above-average ('2') or above-average ('3') business profiles on a ten-point scale ('10' equals high risk, while '1' equals low risk).[1] The business risk scores of water utilities are generally either '2' or '3' also.[2] Since Ms. Freetly's task was to estimate the cost of equity for the gas and water operations of SBWGE, sample groups with average business profile scores of 3 adequately represent the level of business risk inherent in those industries.

SBWGE contends that Ms. Freetly's testimony contravenes the fact that the Commission has consistently allowed a higher cost of common equity for the gas segment of a utility's operation than the electric segment. (SBWGE Initial Brief, p. 41) The Orders cited by the Company are distinguishable and do not establish a consistent Commission policy for allowing higher costs of common equity for gas than electric operations. Since the cost of equity is estimated by relying on market information, the timing and risk characteristics of particular company operations greatly impact cost of equity estimates. Further, the cost of equity for the electric operations of SBWGE are irrelevant to this proceeding and the level of risk corresponding to the gas and water operations of SBWGE. SBWGE did not use the cost of equity for its electric operations in evaluating the reasonableness of its cost of equity recommendation.

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[1] S&P Research: "Keys to Success in the U.S. Gas Distribution Industry," September 25, 2003.
[2] S&P Research: "Consolidation Trend Continues for U.S. Investor-Owned Water Companies," September 4, 2003.

ii. DCF

iii. CAPM

iv. Section 9-230

SBWGE is attempting to establish a higher rate of return on rate base because of its affiliation with Alliant, which is a clear violation of Section 9-230. In contrast, Staff's analysis specifically eliminates the increased risk due to Alliant's investment in non-regulated subsidiaries in order to prevent risks associated with the utility's affiliation with unregulated or non-utility companies from increasing the rate of return on rate base for SBWGE.

SBWGE argues that the adjustment Staff made due to WPL's downgrading is misleading and that Staff's reliance on Section 9-230 to support its return on equity analysis is misplaced. (SBWGE Reply Brief, p. 37) SBWGE's argument is based upon the case of <u>Illinois Bell Telephone Co. v. Illinois Commerce Commission</u>, 283 Ill. App. 3d 188, 210 (1996). However, SBWGE's argument relies upon a flawed interpretation of <u>Illinois Bell</u> and therefore its argument should be rejected. SBWGE first argues that Ms. Freetly "cannot establish how much WPL's cost of capital has increased due to its affiliation with Alliant Energy." SBWGE then argues, "[it] submits that Staff cannot because SBWGE and WPL's capital structure has not been manipulated by Alliant Energy." (SBWGE Reply Brief, p. 37) SBWGE next argues that "the Illinois courts have been clear, when the Commission is to apply Section 9-230 of the PUA" citing <u>Illinois Bell</u>. SBWGE then argues that under <u>Illinois Bell</u> the Commission must go through <u>three steps</u> when applying Section 9-230.

SBWGE's <u>first step</u> is "the Commission must determine if the company is burdened with any incremental risk or increased cost of capital directly attributable to an affiliation with a non-regulated entity." (SBWGE Reply Brief, p. 38) SBWGE's <u>second step</u> is "the Commission must find that the capital structure has not been consciously manipulated" (SBWGE Reply Brief, p. 38) SBWGE's <u>third step</u> is "if the Commission does find the cost of capital has increased because of its affiliation with a non-regulated subsidiary, the Commission must determine the amount of the increase" (SBWGE Reply Brief, p. 38). SBWGE then argues that "[a]bsent a showing of any the above, a violation of Section 9-230 has not occurred." (SBWGE Reply Brief, p. 38) SBWGE then concludes "… Ms. Freetly has not presented any evidence that WPL's cost of capital has increased due to its affiliation with Alliant Energy. Consequently, her reliance on Section 9-230 is baseless." (SBWGE Reply Brief, p. 38) Neither the record nor <u>Illinois Bell</u> support SBWGE's arguments.

SBWGE's analysis of <u>Illinois Bell</u> is flawed. First, <u>Illinois Bell</u> did not address the issue of when Section 9-230 is applied. There is no question as to when Section 9-230 applies. Section 9-230 on its face applies "in any proceeding to establish rates or charges … ." (220 ILCS 5/9-230) Section 9-230 requires the Commission to find that incremental risk or increased cost of capital due to affiliation have been excluded from rates. (Id. at 208) <u>Illinois Bell</u> addressed the issue of how to apply Section 9-230 not when to apply it. Putting aside the fact that <u>Illinois Bell</u> addressed the issue of how to apply Section 9-230, SBWGE's "three steps" do not correctly set forth the Section 9-230 analysis required by <u>Illinois Bell</u>.

Under <u>Illinois Bell</u> the Commission has to determine if the utility is burdened with any incremental risk or increased cost of capital because of its affiliation with unregulated or nonutility companies. (<u>Illinois Bell</u>, at 210) The issue therefore, is whether the utility's affiliation with the unregulated or nonutility companies has "in any way, regardless of mental state of the actors involved, caused [the utility's] risk or capital costs to increase" (Id. at 210) SBWGE misunderstands this part of the analysis. SBWGE argues in its "second step" that "… the Commission must find that the capital structure has not been consciously manipulated." (SBWGE Reply Brief, p. 38) SBWGE's second step is wrong. SBWGE argues that if there has been no conscious manipulation then Section 9-230 does not apply. SBWGE's argument is clearly contradictory to the analysis set forth in Illinois Bell. Illinois Bell was clear that "a finding that [a utility's] capital structure has not been consciously manipulated, with nothing more, will not satisfy section 9-230's requirements. (Citations omitted)" (Illinois Bell, at 210). As required by Illinois Bell, and as set forth above, the Commission "must determine whether [the utility's] affiliation with [the unregulated or nonutility] has in any way, regardless of the mental state of the actors involved, caused [the utility's] risk or cost of capital to increase. (Id.) Even if true, which Staff does not concede, SBWGE's unsupported claim that "SBWGE and WPL's capital structure has not been manipulated by Alliant Energy" (SBWGE Reply Brief, p. 37) does not end the Section 9-230 analysis. As Ms. Freetly testified, WPL's ratings were downgraded due to Alliant's nonregulated businesses. (ICC Staff Ex. 4.0, p.9) As a result, Ms. Freetly's analysis must eliminate that increased risk, which is precisely what she did. SBWGE confuses the specific allegation in Illinois Bell (i.e., that its affiliation with nonutility companies led to a manipulated capital structure) with the broader scope of Section 9-230 set forth in Illinois Bell to not include any increase in a utility's cost of capital resulting from affiliation with unregulated or non-utility companies.

The final part of the Section 9-230 analysis is "… if [the utility's] incremental risk or cost of capital has increased because of its affiliation with [unregulated or nonutility companies], the Commission must determine the amount of the increase. "Any increase then must be removed from the calculation of [the utility's] ROR." (Illinois Bell, at 210) Ms. Freetly testified that the downgrade to WPL was due to Alliant's nonregulated activities. (ICC Staff Ex. 4.0, p. 9) Staff witness Freetly's analysis is consistent with Illinois Bell. If the Commission were to adopt SBWGE's "three step" analysis it would be contradictory to the requirements of Section 9-230 as required by Illinois Bell.

In order to eliminate the increased risk of WPL due to Alliant's higher-risk nonregulated businesses, Ms. Freetly relied on the AA- credit rating that S&P assigned to WPL before Alliant's downgrade due to its expansion into nonutility businesses. If Ms. Freetly did not adjust for the downgrading of WPL, then her return on equity analysis would not have reflected the fact that SBWGE's "exposure to risk is one iota greater" or SBWGE "pays one more dollar more for capital" because of its affiliation with Alliant. (Illinois Bell, at 207)

In Docket Nos. 01-0528/01-0628/01-0629 Consolidated, the Commission ruled that Staff's sample of gas utilities best represented the risk of SBWGE. In that case, Staff relied on the pre-October 17, 2001 S&P credit rating and business profile of SBWGE in forming its gas sample because the downgrade on that date was due to Alliant's "increased focus on expanding its higher-risk, non-regulated businesses." (Order, Docket Nos. 01-0528/01-0628/01-0629 Consolidated, pp. 9 and 13) The Commission adopted Staff's cost of equity recommendation for SBWGE in that proceeding. In this docket, Staff took the same approach to eliminate the increased risk to which the Company is exposed in accordance with Section 9-230.

Although Staff witness Freetly assessed the risk of WPL at the AA- rating level, all three of Staff's sample groups had average S&P credit ratings of A, indicating a lower level of risk than implied for WPL without the affiliation with Alliant. As stated in her rebuttal testimony, Ms. Freetly did not adjust downward her recommended cost of equity for WPL's lower financial risk because the adjustment was de minimus. (ICC Staff Ex. 10.0, pp. 7-8)

6. Overall Cost of Capital Recommendation- *Gas & Water*

Staff's overall cost of capital recommendation remains 8.41% for the gas operations of SBWGE and 8.29% for the water operations of SBWGE. These recommendations incorporate Staff's cost of equity recommendation of 9.87% for the gas operations of SBWGE and 9.64% for the water operations of SBWGE. The record demonstrates that Ms. Freetly's recommendations are based upon the valid application of sound financial theory, while Mr. Bacalao's are not. Therefore, Staff recommends that the Commission adopt Ms. Freetly's recommendations, as outlined below, to set rates in this proceeding.

Overall Cost of Capital for SBWGE Gas Operations

Capital Component	Ratio	Cost	Weighted Cost
Short-Term Debt	2.58%	1.00%	0.03%
Long-Term Debt	39.73%	7.30%	2.90%
Preferred Stock	4.69%	5.50%	0.26%
Common Equity	53.00%	9.87%	5.23%
Total	100.00%		8.41%

Overall Cost of Capital for SBWGE Water Operations

Capital Component	Ratio	Cost	Weighted Cost
Short-Term Debt	2.58%	1.00%	0.03%
Long-Term Debt	39.73%	7.30%	2.90%
Preferred Stock	4.69%	5.50%	0.26%
Common Equity	53.00%	9.64%	5.11%
Total	100.00%		8.29%

F. Cost of Service-*Gas & Water*

1. Gas

In the Company's Initial Brief at page 42, the Company refers to Staff's recommendation of the Average & Peak (A&P) allocator incorrectly as a recommendation for the Average & Excess (A&E) allocator. The Brief is correct in describing all aspects of the allocator in reference to this docket except that the name reference should be the A&P allocator as recommended by Staff. (Co. Ex. SMK-4, pp. 3-4) The Uncontested Issues under Cost of Service Study in the Company's Initial Brief should have read as follows:

> B. Uncontested Issues
>
> Mr. Larry White performed a COSS for SBWGE's water operations. (LJW-1 and corresponding schedules.) Staff did not object to SBWGE's COSS.
>
> Ms. Sonya Kessinger performed the cost of service studies for the SBWGE gas operations. Ms. Cheri L. Harden testified that Ms. Kessinger use of the COSS study allocators that are appropriate for designing gas rates and are the same allocators Staff would use in its COSS except for one specific allocator. (ICC Staff Exhibit No. 5.0 at 3) Ms. Harden recommended that SBWGE utilize the average and peak (A&P) allocator, and proposed new rates (*Id*. at 6)

The references to the "A & E" allocator in the Company's Draft Order should also be changed to the "A & P" allocator. SBWGE did propose new rates based on using the A&P allocator as recommended by Staff. (SMK-4, pp. 2-4 and corresponding schedules)

2. Water

G. Rate Design-*Gas & Water*

1. Rate Design General Discussion
2. Gg-1 Small Service- *Gas*
3. Gg-2 Large Service- *Gas*

Despite it having been nearly 18 years since the last rate increase Staff still recommends the Gg-2 Large Service customers should not shoulder any of the rate increase. Staff's recommendation is supported by Company Exhibits (Company Ex. SMK-3.1, WPE – 2, page 1 of 10, third column of calculations the Rate of Return at Present Rates; ICC Staff Ex. 5.0, p. 7), which demonstrate that the Gg-2 Large Service class has been over-earning by a substantial amount over the Gg-1 and Gg-7 customer classes. Staff's position is supported by the Company's Cost of Service Study (COSS) and the task of designing rates based on the COSS. Rates for this class should not be increased since this class is already paying significantly more than the proposed rate of return. Staff does not believe that rate shock is an issue when rates have not changed for 18 years. Even if the approved rate increases are perceived as rate shock, Staff does not believe that rate shock would be alleviated for the Gg-1 and Gg-7 classes by the very slight increase for Gg-2 rate class customers of 2% described in Company Witness Kessinger's rebuttal testimony at page 5 of Exhibit SMK-4.

If the Commission follows the Company's recommendation for proportionally allocating a different Revenue Requirement, as stated at page 45 of the Company's Initial Brief, the Other Revenue charges should be removed from the Commission's approved total Revenue Requirement. The Commission should then determine the percentage difference between the Commission's approved Revenue Requirement and

Staff's recommended Revenue Requirement. That percentage change should then be applied to each rate that Staff proposed changing. This method would change the rates on a weighted basis.

4. Gg-7 Interruptible –*Gas*
5. Customer and Usage Charges- *Water*
6. Public and Private Fire Water Rates-*Water*

II. Rates, Rules and Tariff Issues-*Gas & Water*

A. Gas Tariff Volume No. 10/11-*Gas*

B. Annual Usage Review Process-*Gas*

C. Service Lateral Costs-*Gas*

D. Water Tariffs through Ill. C.C. No. 8-*Water*

E. Water Tariffs through Ill. C.C. No. 7-*Water*

F. Compliance Tariff Filing-*Gas & Water*

III. Other Issues-*Gas & Water*

A. Original Cost Determination-*Gas & Water*

B. Contract Between WPL and SBWGE for Gas-*Gas*

Staff recommends that the Commission order the Company to file a petition requesting Commission approval of a new gas contract between SBWGE and WPL ("Wisconsin Power and Light Company") within six months of the order in this proceeding. The reason for Staff's recommendation is that the methodology utilized in the current gas contract effectively replaces all direct costs incurred by SBWGE with a percentage allocation of WPL's total costs.

The Company contests Staff's recommendation with numerous arguments, none of which addresses the primary objective of Staff's proposal. As Staff indicated in its Initial Brief, Staff's primary concern is that the rates charged to SBWGE customers reflect, to the extent possible, the actual costs incurred to provide service. Assigning costs directly to SBWGE with allocations only for indirect or unassignable costs that are necessary to provide gas service to SBWGE customers, would accomplish this objective.

First, SBWGE contends that Staff has presented no evidence the current gas contract methodology is unreasonable. SBWGE further contends that Staff has not applied the facts surrounding the gas system, which are different from the water system. (SBWGE Initial Brief, p. 8)

Regarding the two arguments above, Staff has not contended that the current gas contract is unreasonable, nor does Staff need to demonstrate that the current contract is unreasonable in order to recommend that it could be improved. Rather, Staff has argued that the current gas contract should be changed so that rates reflect, to the extent possible, the actual costs incurred to provide service. This objective is Staff's primary concern, and whether the gas or water systems are fully integrated or not is irrelevant to this goal.

SBWGE also argues that the gas utility assets have not been replaced by an allocation and that the costs are directly assigned to SBWGE. SBWGE Initial Brief, p. 9) The Company further contends that the current gas contract first assigns direct costs to

SBWGE and then allocates only incremental costs on assets owned by WPL. (SBWGE Initial Brief, p. 9)

Regarding both of the above arguments, the contested issue turns on whether the current gas contract does, in fact, provide for direct costs and rate base to remain on the books of SBWGE, with only an incremental allocation of indirect costs and rate base from WPL, or whether the current gas contract effectively replaces the direct costs incurred by SBWGE with a percentage allocation of WPL's total costs. Staff addressed this matter at length on pages 54 through 57 of its Initial Brief.

The methodology utilized in the current gas contract effectively replaces all direct costs incurred by SBWGE with a percentage allocation of WPL's total costs. This is apparent from a review of Formulas 2 through 5 of the existing gas contract. (ICC Staff Cross Ex. 2 - Seitz) It is also evident from the allocation of rate base to SBWGE, as detailed on Schedules B-1 and B-6 attached to the direct testimony of Company witness Martin W. Seitz. (Exhibit MWS-1, Schedules B-1 and B-6, respectively)

Schedule B-6 derives the average rate bases for WPL and SBWGE, respectively, and adds the two averages to derive a combined average rate base. The allocation factor is applied to the combined average to derive the total allocation to SBWGE. From that amount the direct SBWGE rate base is deducted to derive the allocation of rate base to SBWGE per the existing contract. This amount is then added back to the direct SBWGE rate base on Schedule B-1. The theoretical effect of this methodology is that the allocation per the contract acts as a plug amount to get the direct SBWGE amount back to the allocated total that was derived on Schedule B-6. The only difference between the total rate base per Schedule B-1, column (D), and Schedule B-6, column (H) is due to the fact that Schedule B-6 uses average balances instead of the year–end balance that appears on Schedule B-1. Given that the current methodology produces costs based on estimated allocations, Staff asserts that actual cost information would be superior to the extent it is available.

The Company contends that the costs and assets that directly relate to SBWGE stay on its books, and only an incremental amount is allocated, based on the formulas. (SBWGE Initial Brief, p. 9) Staff agrees that the direct costs incurred by SBWGE remain on its books, however, the effect of the allocation methodology used by the Company is that regardless of the amount of the direct costs on SBWGE's books, the final amounts on SBWGE's books will reflect the allocation of the combined SBWGE and WPL costs, thereby effectively replacing the direct costs with an allocation.

SBWGE further argues that Staff's recommendation is unsupported because Staff offered "no specific changes to the Gas Contract to demonstrate what changes would make an amended contract 'superior' to the existing Gas Contract." (SBWGE Initial Brief, pp. 9 – 10) Through comparison to the aforementioned Water Services Contract between SBWGE and WPL (ICC Docket No. 03-0462, Order entered March 17, 2004), Staff provided numerous illustrations of the types of changes that would improve the existing gas contract. However, a detailed review of the existing gas contract, including specific changes that the Company refers to in its Initial Brief, is beyond the scope of Staff's recommendation within this rate proceeding. A detailed review of the existing contract is properly conducted within a separate docket, as recommended by Staff.

Finally, the Company argues that "the Commission should reject Staff's proposal because Staff's proposal goes beyond the scope of the Public Utilities Act ("the Act") and Staff does not establish the current Contract is unreasonable". According to Section 7-101(3) of the Act, no contract with an affiliated interest shall be effective unless it has first been filed with and consented to by the Commission or exempted in accordance with the Act. Although the Commission approved the existing gas contract in Docket No. 97-0088, nothing in the Act precludes the Commission from requesting the Company to submit an updated contract for its review.

CONCLUSION

Wherefore, for the foregoing reasons and those set forth in its Initial Brief, the Staff of the Illinois Commerce Commission respectfully requests that the Commission accept Staff's recommendations.

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